BusinessWeek

How Real Was The Prosperity?

By Michael Mandel

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Mark it down. Clear the slate. Get it all behind us.

That's what the big banks are trying to do now. With their massive write-offs, Citigroup, Merrill Lynch, and the other big financial institutions hope to take all of their pain at once. In toto, Wall Street firms have taken roughly $100 billion in losses on their investments.

Yet investors around the world are still remarkably skittish. On Jan. 21 they sent markets in Asia and Europe plunging. The decline was halted--perhaps temporarily--by the Federal Reserve's 0.75 percentage point surprise cut in rates the next morning, and the promise of more to come.

It's possible the combination of Fed rate cuts and quick fiscal stimulus from Washington could keep the U.S. economy out of recession. The Fed originally was created to deal with just this kind of financial crisis, and it's capable of pumping enormous amounts of money into the financial system if needed. "I have a basic faith in the Fed," says Christina D. Romer, an economist at the University of California at Berkeley. "We don't make the kind of mistakes that we used to."

But the underlying problems that ail the markets and the economy cannot be waved away by the Fed's magic wand. In truth, we're at the beginning of a long, arduous process of figuring out how much of the post-tech bubble prosperity was real and how much was the result of a credit-induced frenzy. The answer will determine what we can expect.

The housing markets, of course, overshot as too many buyers took out subprime mortgages they couldn't afford. The outcome will be a decline in home values, with prices in some areas already down.

But the economic writedown is likely to go far beyond housing. Household spending, consumer debt, financial sector profits: All may need a retrenchment, sudden or gradual, to get back to sustainable levels. That's bad news for investors and the global economy, which still depends heavily on U.S. consumption for growth.

There may even be a reassessment of whether recent productivity gains were fueled by excess credit. If growth in productivity slows, the economy will stagnate, real wages will weaken, corporate earnings targets will be harder to meet, and inflationary risks will increase.

There's no way to tell yet how much of the gains of recent years will have to be written down--how much we will have to reduce our expectations for the future. For now, here are some key areas to watch.

PERSONAL SPENDING

The rule for a prudent individual is simple: Don't spend more than you make. For a long time, the U.S. economy obeyed that rule. As far back as the 1960s, personal spending, adjusted for inflation, has basically tracked the overall growth of the economy, as measured by gross domestic product. Sometimes consumers would get ahead of the economy for a few years, and sometimes fall behind, but never for very long.

That pattern changed in the 1990s (chart). As of the third quarter of 2007, the 10-year growth rate for consumption was 3.6%, vs. GDP growth for the same period of 2.9%. This difference represents an enormous gap. If consumer spending had tracked the overall economy over the past decade as it has in the past, Americans today would be spending about $600 billion less a year. The extra spending has amounted to a total of about $3 trillion since 2001.

Where did we spend the money? On housing and health care, of course. But outsize gains also came in clothing, furniture, recreation equipment, motor vehicles, and consumer electronics--all areas where prices have fallen and imports have surged.

The question now is how much of that extra $3 trillion we will have to give back. Will real consumer spending in the U.S. lag the broader economy for several years? If so, the impact is likely to be felt on imports, since outlays for necessities such as food and health care should stay strong. Alternatively, the increase in real spending could turn out to have been a rational response to globalization and the flood of cheap goods from overseas. In that case, consumer spending may not fall off--but it's not likely to grow faster than the rest of the economy.

CONSUMER LENDING

The past 10 years will go down as one of the greatest consumer-lending sprees ever. Adjusted for inflation, consumer debt--including mortgages--rose an average 7.5% per year since 1997, far faster than the 4.2% rate of the previous 10 years (chart). The last time debt rose so fast was the 1960s, as the postwar generation bought homes and autos. If Americans had kept borrowing at their pre-1997 pace, they would have had about $3 trillion less in debt.

The extra debt also represents a formidable obstacle for banks and other financial institutions that might want to lend more to consumers. "Going forward, we're not going to see this credit-driven growth," says Alistair Milne, a professor and banking expert at City University in London. "Banks are saying, 'we have to be more careful here.'"

CORPORATE EARNINGS

Yes, there's been a profit boom in recent years. Corporate earnings, as measured by government statisticians, have averaged 8% of GDP over the past decade, up from a low of 6.5% in the early

'90s. That has helped propel stocks upward.

But here's an unfortunate truth--the profit surge has been mainly in one area, financial services. Financial institutions have benefited from the consumer credit boom, the proliferation of new financial instruments, and relatively low rates. By contrast, the earnings of nonfinancial companies over the past decade have averaged about 5.3% of GDP, about the same since the mid-1980s. There are few signs of any acceleration, even after years of restructuring.

The question now is how much of the gain in financial profits is sustainable and how much will simply evaporate once the credit binge is over. The problem: No one knows yet how badly the banks will be hit.

PRODUCTIVITY

Now we come to the trickiest area. The clearest sign of U.S. economic health has been growth in productivity, or output per hour worked. The faster productivity rises, the faster the economy grows without inflation, and the higher living standards go. Over the past 10 years, productivity, as measured by the Bureau of Labor Statistics, has grown at a 2.6% annual pace. That's up from a 1.6% annual rate over the previous decade. This extra point of productivity growth means the annual output of the U.S. economy is about $1 trillion higher than it would have been otherwise. Yet despite the higher output, U.S. consumers have taken on an extra $3 trillion in debt. This is a bit like someone who gets a raise, then goes and spends the money--and more--on a new car.

Some of those apparent productivity gains also may be illusory. If the economy was artificially boosted by excess borrowing, that would show up as higher output and, presumably, higher productivity. The implication is that once borrowing recedes to the historical average, actual underlying productivity growth might be lower than we thought.

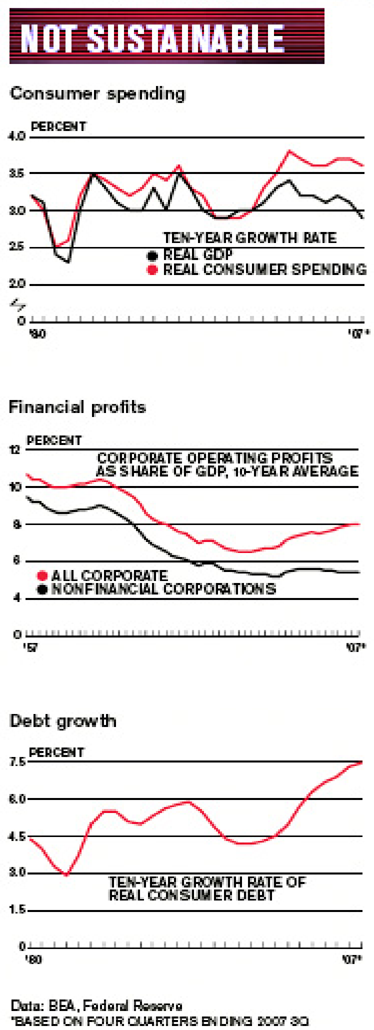
The outcome won't become clear for a while. But if productivity growth is slower, then the economy's "speed limit"--the maximum growth rate that doesn't push up inflation--would be lower. Presumably, a slower-growing, less productive U.S. would become less attractive to foreign investors

THE STOCK MARKET AND GLOBAL GROWTH

Investors probably have already taken into account the possibility of a mild U.S. recession. But the reason why the stock market hasn't fallen further--besides the Fed rate cuts--is the belief that the global economy will continue to grow, eventually helping multinational companies such as General Electric.

But no one knows whether a U.S. consumer slowdown will undermine the world economy. It's unclear if Americans are more likely to cut back on imported LCD TVs or Starbucks coffee. The other question is the extent to which a consumer slump in the U.S. will affect business investment overseas. Factories are springing up in China and elsewhere to feed American demand. What if that demand falls?

These are sobering questions to consider. One consolation: The American economy can produce pleasant as well as nasty surprises. Many foresaw the tech bubble of the 1990s bursting; few predicted the housing boom that followed. Maybe a new force will emerge to propel the economy forward and keep spending robust. Right now, that's what everyone wants to know.



A trader checks out the Big Board during the wild ride on Jan. 23 Richard Drew/AP Photo

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